PATENT ASSETS: INCREASED EMPHASIS, NEW CONCERNS – PART 2

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POST-INTERFERENCE EX PARTE PROSECUTION BY A LOSING APPLICANT INTERFERENT

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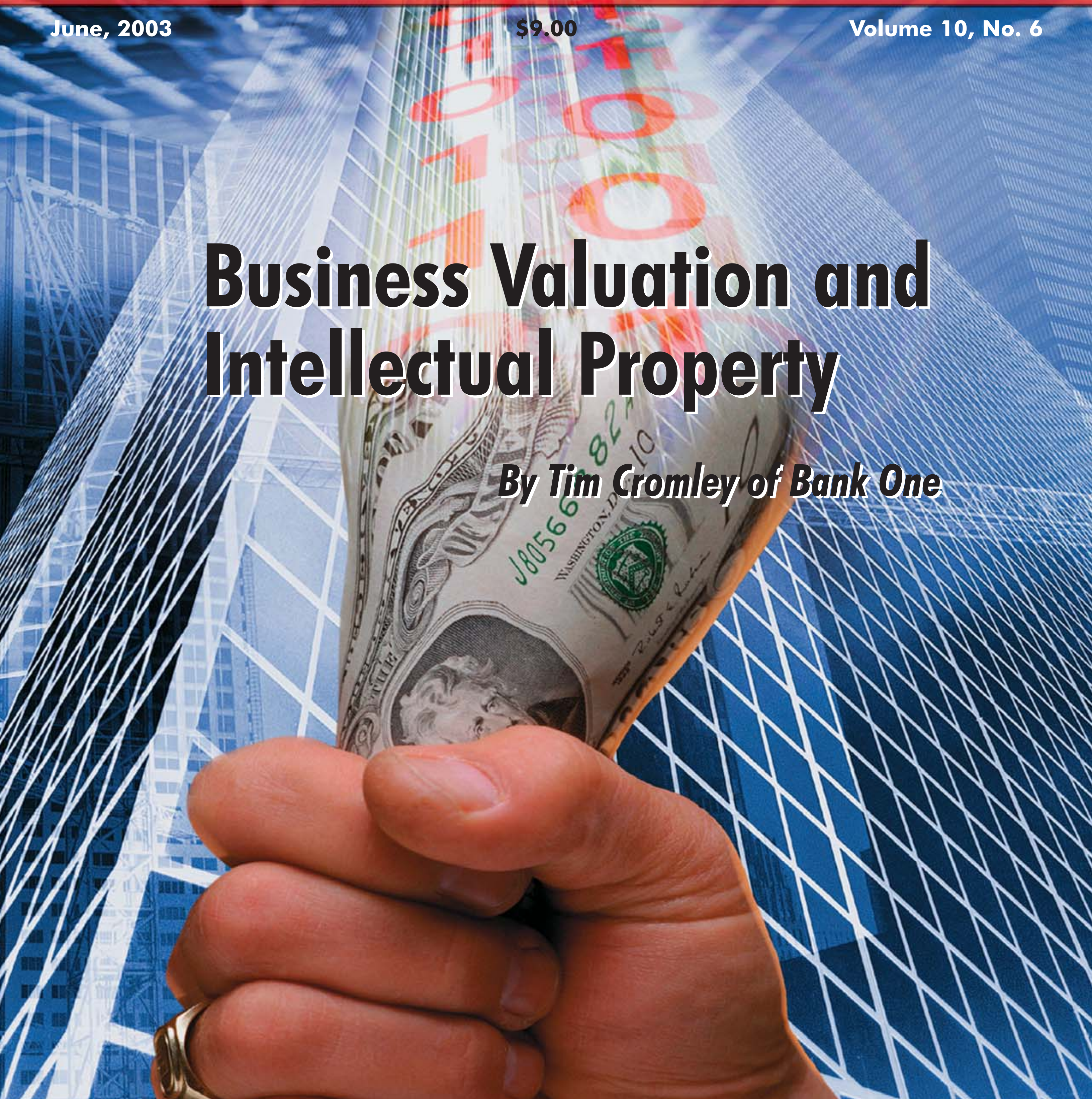

Business Valuation and Intellectual Property

By Tim Cromley of Bank One

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Intellectual property evaluation can be an important part of a business valuation, but standards for valuing intellectual property are lacking (according to this article). Because this article was written for persons who are not necessarily familiar with the business appraisal profession, this article also includes descriptions of some basic appraisal approaches, as well as suggested criteria for selecting a business appraiser.

NEED FOR PROFESSIONAL BUSINESS APPRAISAL [i]

A formal, professional business valuation can be useful in the following cases: estate and gift tax planning, negotiating business deals, determining goodwill impairment, developing and managing an employee stock ownership plan (ESOP), re-capitalizing a business, deciding whether to buy a closely held business or sell a business segment, and for other purposes. To avoid the time and expense of a professional business valuation, decision makers sometimes estimate business value based on:

- Book value;
- Rules of thumb;
- A formula stated in a buy-sell agreement;
- A value stated in an old appraisal report; or
- A value based solely on the isolated purchase of stock by a shareholder.

Although quick valuation approaches may be considered in a business valuation, exclusive reliance on them is risky. Cursory valuation approaches can result in costly litigation and can damage the reputation of the unwary user or practitioner. In one case, a court held that ESOP trustees had breached their fiduciary duty by relying on an outdated valuation report, although the report was less than two years old.[2] In another case, the Supreme Court of Delaware held that the directors of a corporation had breached their duty of care by recommending the acceptance of a merger offer without informing themselves about the intrinsic value of the corporation.[3]

BUSINESS VALUATION APPROACHES

Currently, the American Society of Appraisers (ASA)[4] has business valuation standards for three distinct approaches to business valuation, as follows:

- Asset-Based
- Income
- Market

ASSET-BASED APPROACH

The first of these approaches, the Asset-Based Approach, is based on the following formula:

ASSETS – LIABILITIES = OWNER'S EQUITY

The Asset-Based Approach uses the appraised values of assets to restate the accounting balance sheet of the business being valued, since generally accepted accounting principles do not necessarily reflect current value. In this approach, the value of the total equity interest in a business is the appraised value of all of the assets of the business less the value of all its liabilities. Thus, an *increase* in the appraised value of the assets of a business will tend to *increase* the value of the owner's equity in the business, and *vice versa*.

Within the Asset-Based Approach to Business Valuation, there are three principal ways to value an *asset*, as follows:

1. The Market Approach—This approach is most reliable when there is an active market in similar properties.
2. Income Approach—In one variant of this approach, the appraiser forecasts net cash flows (e.g., net royalties) likely to be generated by the asset, then discounts those cash flows back to present value.
3. Cost Approach—This approach is based on the principle of substitution—i.e., a prudent buyer will not pay more for a property than the cost of acquiring a substitute property of equivalent utility.[5] In a typical variant of the Cost Approach, the appraiser determines what it would cost to replace an asset, and then allows for functional and economic obsolescence, as may be appropriate.

In some business valuation circles, the Asset-Based Approach to Business Valuation is often omitted. Reasons for this are as follows:

1. The Approach may require the use of a real estate or equipment valuation, which is often unavailable. Also, the development of real estate and equipment valuations is generally considered not to be within the purview of business appraisers.
2. The Approach often requires the valuation of intangible assets. However, professional appraisal groups[6] do not have valuation standards specifically targeting the valuation of intellectual property or other intangible assets, even though the appraisal of such assets is within the purview of business appraisal[7]. *The current lack of such standards creates an additional risk in the valuation of such assets*. This gives some appraisers pause because of the additional risk involved.
3. Because the Approach often requires a team of appraisers representing different appraisal disciplines (real estate, equipment and business appraisers), it is often more costly to apply than alternative business valuation approaches—e.g., Market or Income Approaches.

For such reasons, and unless there is an over-riding benefit to its use, business appraisers will tend to reject an Asset-Based Approach to Business Valuation.

Running counter to this tendency is the relevance of this approach to the valuation of businesses having potentially significant intellectual properties. One could argue that a contributing factor to the so-called "dot.com bubble" was the failure of investors to realistically assess the value of the intellectual properties of the dot-com companies.

With intellectual property playing an increasingly important role in the American economy, it would seem that the stage is set for the development of intellectual property valuation standards. At the very least, the development of such standards would enable business appraisers to more confidently employ an Asset-Based Approach in the valuation of businesses having significant intellectual properties.

MARKET APPROACH

Business appraisers typically value normal operating businesses, at least in part, by using the second of the listed business valuation approaches—i.e., the Market Approach. In one variant of this approach, an appraiser develops valuation multiples based on published market prices of the stocks of corporations engaged in a similar line of business. In another variant of the Market Approach, the appraiser employs transaction data from the sale of comparable businesses.

In either variant, the comparability of the intellectual properties of the comparable businesses may be an issue. Where there are significant differences between the subject business and comparable businesses, appropriate adjustments often are made to account for such differences.

INCOME APPROACH

Business appraisers also generally value normal operating businesses, at least in part, by using the third of the listed business valuation approaches—i.e. the Income Approach. In one variant of this approach, a Discounted Cash Flow (DCF) analysis is performed with free cash flow defined as follows:

Earnings before Interest and Taxes

Minus

Provision for Expected Income Tax Payments

Plus

Depreciation and Amortization Expense

Minus

Capital Expenditures

Minus

Incremental Working Capital Additions

Equals

Free Cash Flow

In the DCF variant of the Income Approach to Business Valuation, free cash flow is projected into future periods and discounted to indicate a present value, using a discount rate that is consistent with the projected cash flows. The cash flow should include the expected contributions of any valuable intellectual properties of the business, and the discount rate should reflect the related risks of those properties.

USPAP STANDARDS

In 1989, the Appraisal Foundation, a group recognized by the U.S. Congress as a source of appraisal standards, adopted the Uniform Standards of Professional Appraisal Practice (USPAP). USPAP standards include sections on Real Estate, Personal Property, and Business Appraisal.

While Standards 9 and 10 of USPAP 2003 (the primary *business* valuation standards of USPAP) use the phrase "business or intangible asset appraisal" several times, they target the specifics of *business*—not *intellectual property*—valuation.

For example, the business valuation standards within USPAP require identification of restrictive clauses in *corporate* charters and *partnership* agreements, but do not give analogous guidance on how *intellectual properties* are to be valued or investigated. In fact, these standards are entirely *silent* about such potentially important *intellectual property* valuation matters, such as the following:

- The advisability of checking the *registration status* of a patent, copyright or trademark.
- The advisability of conducting an investigation into the replacement costs of trade secrets and the strength of their legal protections.
- The advisability of considering the *prosecution history* of a *patent* and the possible existence of a blocking patent.

On February 19, 2003, the Appraisal Standards Board of the Appraisal Foundation published a concept paper inviting comments on whether there are "any other topics that should be addressed" in its business valuation standards.[8] The request by the Appraisal Standards Board for comments concerning its standards for business valuation is a promising development. Since intellectual properties are unique and often quite valuable, the author is hopeful that the Appraisal Standards Board will consider the benefits of developing differentiated standards for the valuation of such assets.

Should a paragraph specifically targeting patents, trademarks, copyrights and trade secrets be added to the next revision of the Business Valuation standards of USPAP?

Perhaps one could be added, along the following lines:

> *In conducting an appraisal of an intangible asset, or of a business with intangible assets of potentially great but uncertain value, the appraiser should investigate:*
>
> - *Patent, trademark or copyright registrations and the extent to which property rights may have been limited during registration proceedings.*
> - *Measures taken to ensure the secrecy of trade secrets.*
> - *The impact of prior litigation, licensing agreements or adversely held rights on the value of the asset.*
> - *The possibility that the asset may have a higher value if it were licensed or sold rather than kept in its existing use.*
>
> *Appraisers should seek information about the asset from an attorney having familiarity with it, and in the case of key patents and trademarks, should also avail themselves of information at www.uspto.gov.*

While the above is surely not a perfect solution, the adoption of *some* intellectual property valuation standards is desirable. Comments on such (or other) aspects of the business valuation standards of USPAP can be submitted via email to comments@appraisalfoundation.org. Individuals wishing to see the existing business appraisal standards of USPAP for comparison can order a copy of USPAP 2003 at www.appraisalfoundation.org/.

NEED A BUSINESS APPRAISER?

A business appraiser is someone who belongs to a diverse lot. Accordingly, if you should ever know of someone needing a business appraiser, you may wish to advise by asking of the following questions:

- If the valuation involves technology, does the appraiser have a degree in science or engineering?
- If the valuation is for litigation, does the appraiser have legal training, or experience testifying in valuation matters?
- If the valuation is for accounting, is the appraiser a CPA?
- If the valuation is for a transaction, does the appraiser have significant transac tional experience?
- If the valuation is extraordinary or very important, is the appraiser a leader in the valuation profession—e.g., someone who has published widely on business valuation or served in professional leadership positions?
- If the valuation assignment is large, how many full-time experienced associates, including accredited valuation professionals, are in the valuation group?

Independence is an additional criterion for selecting an appraiser. Independence adds to credibility and is sometimes mandatory. For example, the Sarbanes-Oxley Act of 2002 prohibits a registered *public* accounting firm from concurrently providing certain non-audit services to their *public* accounting clients, including appraisal services. Interestingly, pressure from Sarbanes-Oxley regulations is producing changes in *private* companies as well, with nearly a quarter of respondents in one survey hiring an *independent* firm for consulting work.[9] Of course, independence is also a state of mind. As stated in the American Society of Appraiser's *Principles of Appraisal Practice and Code of Ethics:*

> The primary objective of a monetary appraisal is determination of a numerical result…. This numerical result is objective and unrelated to the desires, wishes, or needs of the client who engages the appraiser to perform the work. The amount of this figure is as independent of what someone desires it to be as a physicist's measurement of the melting point of lead or an accountant's statement of the amount of net profits of a corporation. All of the principles of appraisal ethics stem from this central fact.[10]

Professional accreditation in business valuation is another criterion for selecting an appraiser. For its "ASA" credential in business valuation, the American Society of Appraisers (the oldest and only major appraisal organization representing all of the disciplines of appraisal specialists[xi]) requires a college degree or equivalent, plus:

1. 5-years full time experience in business valuations.
2. The submittal of two, business valuation reports for peer review and approval.
3. Passage of an examination in USPAP standards.
4. Passage of professional examinations in ethics and valuation principles.
5. Having 100 hours of continuing education (or equivalent) for re-accreditation.

In the author's opinion, ASA accreditation in business valuation, or its *equivalent*, is a particularly fair and useful criterion for selecting a business appraiser, as its requirements are most reasonable, and as requirements one through three above set the ASA credential somewhat apart from other similar credentials.[11]

SUMMARY AND CONCLUSIONS

In summary, key points of this article are as follows:

1. Professional business appraisals are useful for a variety of purposes.
2. Cursory business appraisal methods are often risky.
3. Current business appraisal standards do not address any issues unique to intellectual property.
4. A need exists for the development of business appraisal standards that recognize the unique issues of intellectual property (and the contributions that experts in intellectual property can make).
5. The Appraisal Standards Board of the Appraisal Foundation (a private group commissioned by Congress to develop appraisal standards) plans to deliberate beginning on June 27, 2003, about possible changes to its business valuation standards for the years 2005 and later. Persons favoring development of IP valuation standards can so inform the ASB via email at communicate@appraisalfoundation.org.[13] IPT

ENDNOTES

1. This introductory section was derived in large measure from the author's previous article entitled *Conducting a Business Valuation*, The Management Advisor (Warren, Gorham & Lamont, Spring 1988).
2. *Donovan v. Cunningham*, 716 F.2d 1455 (5th Cir. 1983).
3. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. Super. 1985).
4. Founded in 1936, the ASA is the oldest and only major appraisal organization representing all the disciplines of appraisal specialists (see About ASA at http://www.appraisers.org/about/).
5. Valuing Machinery and Equipment, American Society of Appraisers, Washington, D.C., 2002, p. 45.
6. Other professional societies, besides the ASA, that accredit business appraisers include the American Institute of Certified Public Accountants, the Institute of Business Appraisers, the National Association of Certified Valuation Analysts, and the Canadian Institute of Chartered Business Valuators. As far as the author can ascertain, none of these groups requires any significant training in intellectual property valuation, nor has any standards *specifically targeting* the valuation of *intellectual property*.
7. *Definitions*, Business Valuation Standards, American Society of Appraisers, Washington, D.C., 2002, p. 21.
8. *Topic K*, ASB Concept Paper on a Comprehensive Review of STANDARDS 9 and 10, February 19, 2003. See http://www.appraisalfoundation.org/.
9. "Private Companies Take Action in Response to Sarbanes-Oxley," News Flash, Center for Corporate Financial Leadership, April 3, 2003.
10. *Objective Character of the Results of an Appraisal Undertaking*, Principles of Appraisal Practice and Code of Ethics, American Society of Appraisers, http://www.appraisers.org/join/code_ethics.htm#2.2
11. *About ASA*, American Society of Appraisers, http://www.appraisers.org/about/
12. See *Professional Accreditation Criteria*, Judges and Lawyers Business Valuation Update, January 1999, page 3, at http://www.bvappraisers.org/why_hire/accred_chart.pdf
13. According to ASB Concept Paper on a Comprehensive Review of STANDARDS 9 and 10, February 19, 2003, written comments may be submitted to: ASB Comments, The Appraisal Foundation, 1029 Vermont Avenue, NW, Suite 900, Washington, DC 20005-3517. Comments may also be submitted by facsimile to (202) 347-7727 or (202) 624-3053 or by e-mail to comments@appraisalfoundation.org.